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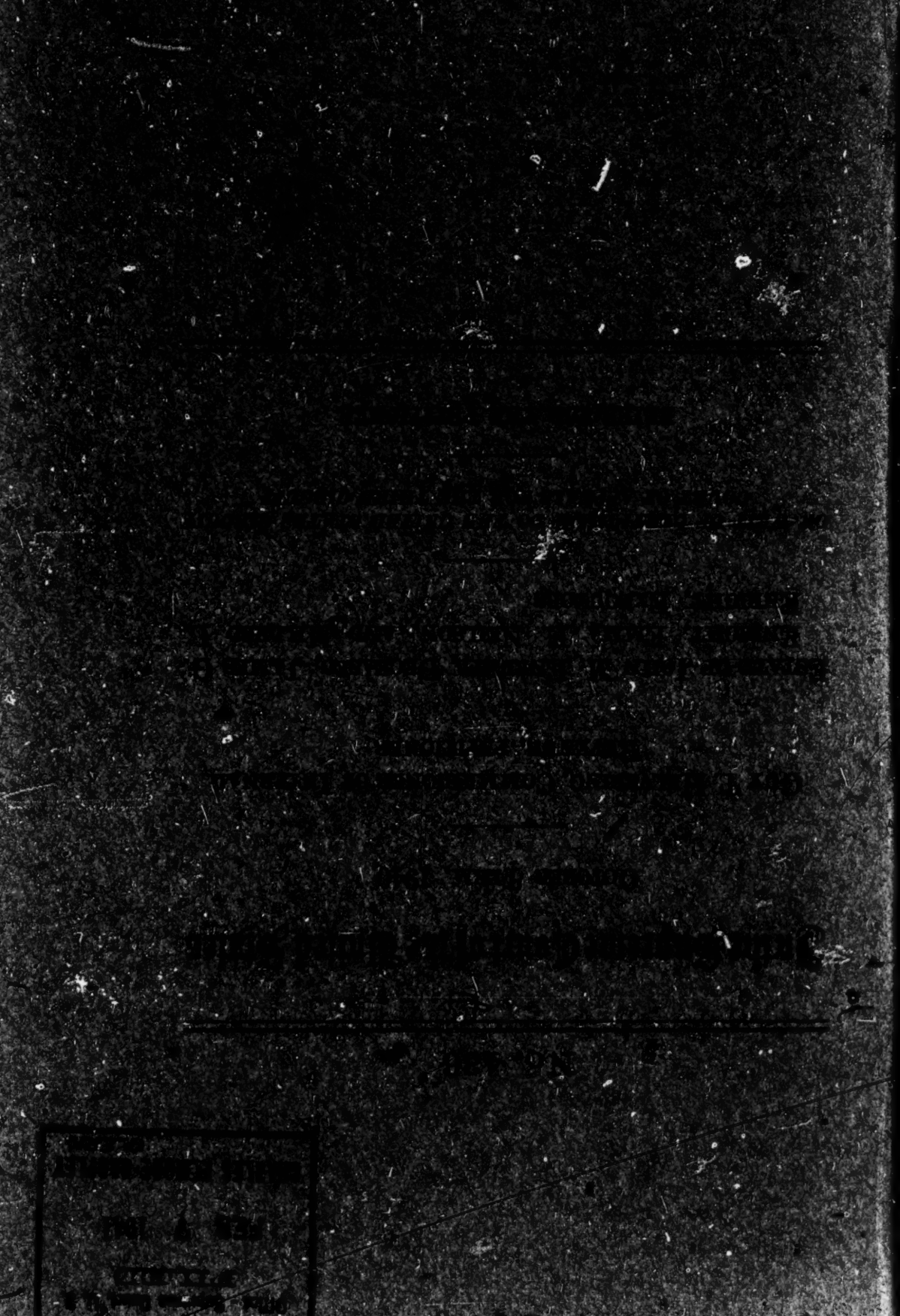

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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 436

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ESTATE OF JOHN M. ENRIGHT, DECEASED, JAMES G. ENRIGHT, EMMA E. NEILSON, AND MILDRED L. ENRIGHT, EXECUTORS

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOF THE PETITIONER

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 12–15) is not officially reported. The opinion of the Circuit Court of Appeals (R. 34–37) is reported in 112 F. (2d) 919.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on June 17, 1940 (R. 38). The petition for a writ of certiorari was filed September 14, 1940, and granted November 12, 1940. The juris-

diction of this Court rests upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether a deceased partner's share of income earned, but not yet received, by the partnership should be included in the gross income of the partner for the taxable period ending with his death, where both the partnership and the partner kept books on the cash basis.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in the Appendix, *infra*, pp. 35–41.

STATEMENT

The relevant facts, as found by the Board of Tax Appeals (R. 13–15) on the stipulation (R. 25–33) and testimony (R. 22–25), may be summarized as follows:

John M. Enright, up to the time of his death on November 19, 1934, was senior partner in the firm of McDermott, Enright & Carpenter, engaged in the practice of law in Jersey City, New Jersey (R. 25). The net income of the partnership, which reported income upon a calendar year cash receipts basis, was distributable as follows (R. 26):

	Percent
John M. Enright	34½
James D. Carpenter, Jr.	34½
Howard C. Gilmour	13
Carl S. Kuebler	9
Patrick A. Dwyer	9

The partnership agreement, in part, read (R. 26):

> (5) In the event of the retirement through death or otherwise of the present members of the firm, Messrs. Enright and Carpenter, or either of them, it is agreed that the interest of such retiring member shall consist of his interest on the above percentage basis in the net monies then in the treasury of the firm, plus his like percentage in the outstanding accounts and the earned proportion of the estimated receipts from unfinished business. The value of such outstanding accounts and unfinished business shall be determined if possible as of the effective date of such retirement, by the joint agreement of such retiring member or his personal representative, and the senior remaining partner. * * *
>
> The amount so determined shall be paid by the remaining members who elect to carry on the firm, in equal monthly instalments, within eighteen months from the date of such retirement.

The decedent by his last will made the following provision (R. 27):

> EIGHTH: In settling my interest in the law firm of McDermott, Enright & Carpenter, I direct my executors to accept the valuation of the various items of business in the hands of the firm as fixed by my partner James D. Carpenter, Jr., and to accept payment for my interest therein upon such terms of

credit as my said partner may deem reasonably necessary for the liquidation thereof out of the business.

The surviving partners formed a new partnership immediately after the death of Enright and continued the practice of law. The new agreement provided that "the earned proportion of the estimated receipts from unfinished business of the former firm shall be determined by the said James D. Carpenter, Jr., whose decision thereon shall be binding and conclusive * * *" (R. 27).

At the date of his death, Enright's interest in partnership cash was $4,143.81 and his interest in collectible accounts receivable was $2,055.55. The partnership at that time was handling over 400 pending cases in which work had been done and on which additional work had to be done before the amount of fees to be charged could be determined and billed to clients. The share of Enright in cases being handled upon the basis of a fixed fee was $1,024.89, payable after his death upon a monthly or yearly basis. Almost all other cases pending were being handled upon understandings with clients that the fee would be a reasonable amount for work done, taking into account results, time and effort, and the amount involved. Only a few cases were being handled upon a contingent fee basis and such cases Carpenter valued in his estimate at one dollar each (R. 28–29). Carpenter determined that the firm had earned by

work upon these cases up to November 19, 1934, about $118,422.51 and that Enright's proportionate share was $40,855.77 (R. 28). The amount estimated as Enright's share of earned fees on unfinished business would not have been realized in full had the new firm not completed the business (R. 14). The $2,055.55 item and the $40,855.77 item, or $42,911.32, were reported as a part of Enright's estate for state and federal inheritance tax purposes (R. 28).

The successor firm did not buy the decedent's interest in the former firm. As it made collections on the business of the old firm it turned Enright's share over to his estate. Up to the date of the hearing the new firm had collected $46,293.75 upon Enright's share of old business and had paid $45,965.15 to the estate (R. 29–32).

The executors filed an income tax return for Enright for 1934 and included only his share of the partnership cash, $4,143.81. The Commissioner determined a deficiency and added $42,911.32, representing Enright's share of accounts receivable and his share of estimated earnings to the date of his death (R. 14). Enright was on a cash basis and did not receive any of the $42,911.32 in controversy (R. 14).

The Board of Tax Appeals determined that the decedent's share of accounts receivable and estimated earnings for the period ending with his death should be included in his gross income for

that period (R. 15). On appeal, the Circuit Court of Appeals for the Third Circuit, with Judge Biggs dissenting, reversed the decision of the Board.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the decedent's share of profits earned, but not yet received; by the partnership should not be included in his gross income for the period ending with his death, within the meaning of Section 42 of the Revenue Act of 1934.

2. In failing to hold that the decedent's share of income earned, but not yet received, by the partnership should be included in his gross income for the period ending with his death, within the meaning of Section 42 of the Revenue Act of 1934.

3. In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

The decision in *Guaranty Trust Co.* v. *Commissioner,* 303 U. S. 493, sets forth the principles that are controlling here. There, the argument was made on behalf of the decedent partner that the income computing and reporting method used by the firm should be conclusive in determining the income attributable to the decedent. This Court rejected the contention. It observed that upon the death of the taxpayer his surviving partners were bound to account to him for the profits as of that date. It then held that the final accounting to as-

certain the decedent's interest, not the periodic firm accounting, is the one determinative of the income of the decedent for the period ending with his death. The case of *Bull* v. *United States,* 295 U. S. 247, sheds further light on the problem. In that case the partnership agreement provided that at its option the estate of decedent could participate in the firm for one year just as the decedent could, if living. Certain profits *earned* both before and after the death of decedent were paid over to his estate. This Court held that the profits *earned* prior to his death were taxable as income earned by the decedent in his lifetime while those *earned* subsequent to his death were taxable as income to the estate. In the case at bar the situation is the same in essential respects. Upon the death of Enright his surviving partners were bound to account for his interest in the firm. Such an accounting was made and his interest ascertained in the cash, outstanding accounts and the earned proportion of the estimated receipts from unfinished business. The firm had no capital and no goodwill accounts. The items ascertained as decedent's share and later liquidated and paid to his estate were derived wholly from personal services performed prior to his death. They are therefore taxable as income earned by him during his lifetime under the *Bull* and *Guaranty Trust* cases.

The same result follows under the provisions of Section 42. The legislative materials make

abundantly clear the purpose of Congress to close the gap in the income tax resulting from a series of decisions that income earned but not received during his lifetime by a taxpayer on a cash basis of accounting was not taxable as income to him and was capital to his estate. In Section 42 Congress remedied the situation by providing, in effect, that there shall be included in computing the gross income of every decedent for the period ending with his death all amounts earned up to the date of his death. There is nothing in the statutory partnership accounting provisions which indicates that income earned in partnership transactions during the decedent's lifetime should, alone, escape the reach of Section 42 and thus escape all taxation as income.

All the items here sought to be taxed as income to the decedent clearly are within the critical words "amounts accrued up to the date of his death" in Section 42. Even under the strictest criteria as to when an item "accrues" the evidence in this case supports the finding of the Board. In addition, the Government urges that the so-called "accrual basis" of accounting has no precise meaning apart from the circumstances of a particular taxpayer's case. The relevant statutory and legislative materials demonstrate that the so-called "accrual basis" means that basis of accounting which truly reflects income. It is apparent, we submit, that all items derived from the personal services of the decedent must be included in his return in order

to reflect accurately the income earned by him in his lifetime. This result is essential to avoid nullification of the purpose of Congress in enacting Section 42 to prevent the escape of any income from taxation as such.

ARGUMENT

A DECEASED PARTNER'S SHARE OF INCOME EARNED, BUT NOT YET RECEIVED, BY A PARTNERSHIP SHOULD BE INCLUDED IN HIS GROSS INCOME FOR THE TAXABLE PERIOD ENDING WITH HIS DEATH

The decedent at the time of his death in November 1934 was practicing law as a member of the firm of McDermott, Enright & Carpenter, a New Jersey partnership. The records of the firm show no capital interest for the partners and no goodwill account. Under the agreement of the partners each one upon retirement from the firm, either through death or otherwise, was to have his interest ascertained, as of the effective date of such retirement, in a manner stated.[1] The interest of decedent upon retirement was to be thirty-four and one-half per centum of the following: the cash

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[1] New Jersey Revised Statutes (1937), Vol. II, Title 42:
42:1-31. *Causes of Dissolution.* Dissolution is caused:

* * * * *

4. By the death of any partner;

* * * * *

42:1-43. ***Right to accounting on dissolution.***—The right to an account of his interest shall accrue to any partner, or his legal representative, as against the winding up partners, or the surviving partners, or the person or partnership continuing the business, at the date of dissolution, in the absence of any agreement to the contrary.

then in the treasury, the outstanding accounts, and the earned proportion of the estimated receipts from unfinished business. The decedent's interest in each of these items was ascertained, as of the date of his death, by one of his partners and the amount thus ascertained was paid over to his executors during the years 1934 to 1939 out of the liquidation of the business of the original firm. It is stipulated that the successor law firm did not buy the decedent's interest in the original firm (R. 32). The decedent and the firm kept accounts for income-tax purposes upon a calendar year, cash-receipts basis.

The sole question presented is whether the interest of the decedent in the outstanding accounts and the earned proportion of the estimated receipts from unfinished business, ascertained as of the date of his death, may be included in his gross income for the period ending with his death.

1. (a) The case of *Guaranty Trust Co.* v. *Commissioner,* 303 U. S. 493, sets forth the principles that are controlling here. There, upon the death in December 1933 of the taxpayer who was a member of a New York partnership, his surviving partners ascertained his share of the profits to the date of his death and in January and February 1934 paid the amount ascertained to his executor. The firm and the taxpayer each kept books for income tax purposes on a cash basis but the firm, unlike the partner, had a fiscal year ending on July 31st rather than a calendar year. It was urged on be-

half of the taxpayer that the income computation on the return of the firm should be conclusive and, since the firm reported income for the preceding 12 months only on July 31st, that no income derived through firm transactions after July 31, 1933, should be included in the gross income of the decedent taxpayer for the period prior to his death in December 1933. The basis of the contention was that under the partnership accounting provisions of the applicable revenue act only the distributive share of the firm's net income "for any taxable year of the partnership ending within his taxable year" was to be included in computing the income of the partner.

The contentions advanced in this case on behalf of the decedent taxpayer are similar in essential respects to those made in the *Guaranty Trust* case. Here, too, the argument is made that the income computing method used by the firm should be determinative and, since the outstanding accounts were not reported as income during 1934 to the firm on a cash receipts basis, that the interest of the decedent in the accounts cannot possibly be income to him either.

The answer given by this Court in the *Guaranty Trust* case is applicable to the case at bar. The system of reporting periodic income used by the firm is not determinative because, upon his death, the decedent's interest in the income derived through his personal services in conjunction with those of his partners is ascertained in a single, final

accounting.[2] This rationale is implicit in the decision. In that very case, for example, if the firm system of computing income were controlling the decedent's distributive share of the income earned between July 31st and December would never have "accrued" to him within his taxable year. It would not have been ascertained until the next accounting period of the firm.[3] This Court rejected the argument. It held that the final accounting to ascertain the decedent's interest, not the periodic firm accounting, is the one determinative of the income "accrued" to the decedent up to the date of his death (303 U. S. at 499).

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[2] The New York Partnership Act involved in the *Guaranty Trust* case (303 U. S. at 495n.) is identical in relevant part with the New Jersey statutes involved here (pp. 39–41, *infra*). The Court stated (303 U. S. at 495):

"Both by the practical construction given to the partnership agreement by petitioner and the surviving partners, and by the applicable provisions of the New York Partnership Act,[a] decedent's death dissolved the partnership, terminated his right to share in the profits, and fixed the date as of which the surviving partners were bound to account for the profits. *Darcy* v. *Commissioner*, 66 F. (2d) 581. Decedent's estate in fact received the profits accrued on the date of his death, and partnership profits thus accrued and distributable by reason of the death of a partner are his income, taxable as such. *Bull* v. *United States*, 295 U. S. 247.

[a] New York Partnership Act, Laws of 1919, c. 408.

[3] At the next accounting period, July 31, 1934, the firm in liquidation might have reported zero income as a result of losses sustained in the period from December 1933 to July 31, 1934. Compare *Heiner* v. *Mellon*, 304 U. S. 271. Even so, we submit, the result in the *Guaranty Trust* case would have been the same. Therefore, the periodic firm report of income must be irrelevant in this situation.

It is not material that the decedent's interest ascertained on a final accounting should ever have been distributable to him during his lifetime. This Court observed in the *Guaranty Trust* case that the amount of the decedent's interest was not paid until January of the year following death and the Circuit Court of Appeals (89 F. (2d) at 692), which was affirmed, stated that no profits earned after July 1933 were received or were receivable by the decedent up to the time of his death. The basis of this Court's decision in this respect was stated thus (303 U. S. at 496): "Decedent's estate in fact received the profits accrued on the date of his death, and partnership profits thus accrued and distributable by reason of the death of a partner are his income, taxable as such. *Bull* v. *United States*, 295 U. S. 247."

The *Bull* case sheds further light on this matter. There, the decedent was a member of a personal service partnership in which no capital had been invested by the members and which owned no interest in tangible property. The agreement provided that his estate at its option could participate in the firm for a year to the same extent as the decedent could, if living. His share of profits *earned* prior to his death in February 1920 was $24,124.20; the profits *earned* after his death to the end of 1920, and paid to his estate as a member of the partnership (either the old firm or a new associa-

tion) amounted to $212,718.99 (295 U. S. at 255–256). This Court declared (295 U. S. at 254):

> We concur in the view of the Court of Claims that the amount received from the partnership as profits earned prior to Bull's death was income earned by him in his lifetime and taxable to him as such; and that it was also corpus of his estate and as such to be included in his gross estate for computation of estate tax. We also agree that the sums paid his estate as profits earned after his death were not corpus, but income received by his executor and to be reckoned in computing income tax for the years 1920 and 1921.

The import of this language has a direct bearing on the case at bar. In effect the Court held that the death of the partner results in a sharp break between transactions prior to his death and those after. Income *earned* in transactions prior to his death is treated as income earned by the decedent in his lifetime. But income *earned* in transactions subsequent to the decedent's death is taxed to those who participate in them.

The partnership agreement in the case at bar shows that the decedent taxpayer's interest ascertained at death consisted exclusively of earnings created by the activities of himself and his partners prior to his death. The cash and the outstanding accounts clearly had been all earned prior to the date of decedent's death. And, as for the

unfinished business, only so much entered into the computation of his share as consisted of "the earned proportion of the estimated receipts" (R. 26). These items were ascertained to be owing to the decedent as a result of his services performed as a practicing attorney and, therefore, they are all clearly within the definition of income in Section 22 (a) as including "compensation for personal service." See *Irwin* v. *Gavit*, 268 U. S. 161, 166. It follows that the principles stated in the *Guaranty Trust* and *Bull* cases are determinative of the present controversy.

(b) In the *Guaranty Trust* case and, perhaps, in the *Bull* case,[4] the decedent taxpayer's interest ascertained at death was derived from transactions on which payment had been made to the firm. This fact, of course, forms the basis for a contention on behalf of the taxpayer here that the payments in those cases had become income to the firm upon receipt while the outstanding accounts in the case at bar had not become income to the firm prior to receipt. This is urged as a vital distinction. The argument is made that the decedent here cannot be taxed for amounts that have not yet become income to the firm under its system of computing income, since that is the controlling factor. The

[4] The opinion of this Court does not state whether the partnership was on a cash or accrual basis or whether it had received payment for the services rendered. The opinion refers to "the amount received from the partnership as profits earned prior to Bull's death" (295 U. S. at 254).

corrollary of the argument is that all the accrued items would have been taxable to the decedent provided the firm in this case had reported its income upon an accrual basis.

We agree on the latter point. If the firm had been on an accrual basis for reporting income, the decedent's share of the outstanding accounts and other accrued items would clearly be taxable to him. See *Clarence B. Davidson,* 20 B. T. A. 856, affirmed *per curiam,* 54 F. (2d) 1077 (C. C. A. 2d); *Beverly W. Smith,* 26 B. T. A. 778, dismissed on procedural grounds, 67 F. (2d) 167 (C. C. A. 4th). But it certainly does not follow that the items not reported as income under the firm's income computing system cannot be included in the income reported as earned by the decedent up to his death. Any such contention, we submit, is contrary to the *Guaranty Trust* and *Bull* decisions.

The practical implications of the taxpayer's contention may well be considered. It is worthy of note that the basis for reporting firm income has no bearing upon the extent or the character of the decedent's interest or upon the time of payment to him. His share of the cash, accounts receivable, and the earned proportion of the estimated receipts from unfinished business would be ascertained in the same amount and paid out of the liquidation of the business of the old firm within the same time whether the firm used the cash or the accrual basis for reporting income. Since the practical inci-

dents of the final accounting upon the taxpayer's death are unaffected by his firm's system of reporting periodic income, the fact that his firm was on a cash basis appears to be an irrelevancy. The Government contends that the practical incidents of the situation should be controlling.

The difference for income reporting purposes between an annual accounting and a final accounting resulting from the death of a partner is significant. The provisions of the 1934 Act with respect to the computation and reporting of income derived through partnership transactions are derived from the system adopted in the Revenue Act of 1918.[5] Congress there provided that the income from firm transactions might be computed by the firm in the same manner as in the case of an individual and his proportionate share thereof included in computing the income of each member. The tax is levied upon each partner in his individual capacity and is computed only upon his individual income. This system has been followed in all succeeding revenue acts.[6] Such annual income accountings by

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[5] The 1916 Act, Section 8 (e), contained different provisions with respect to the reporting of profits by the partnership (see p. 26, *infra*).

[6] See 1934, 1932, 1928 Acts, Sections 181–182; 1926, 1924, 1921, 1918 Acts, Section 218 (a). The Revenue Acts of March 3, 1917, Section 201, and of October 3, 1917, Section 201, for a time placed an excess profits tax on partnerships as such in addition to the income tax on partners only in their individual capacity. This tax was abandoned the following year. See *Burnet* v. *Leininger*, 285 U. S. 136, 142.

the firm if continued until complete liquidation of firm transactions during the life of all the partners will, on the whole, come reasonably close to showing the practical economic consequences to each member flowing from such transactions. By including his proportionate share of the income so reported in computing his annual individual income each member thus pays a tax upon what actually and practicably may be regarded as his entire income from firm transactions. But the death of a member prior to liquidation of the affairs of the firm disturbs this relationship between the income reported by the firm and included in computing the member's income and the practical economic consequences to him flowing from firm transactions. The reason for this is obvious. Income reported on the return of the firm in years after the member's death is not included in computing his income, for after death he has none. Therefore, the income from firm transactions earned during his life and distributable by reason of his death either must be included in computing his income for the period ending with his death or it will never be included in computing his income.

Considerations such as these appear to be the real basis for the decision in the *Guaranty Trust* case rejecting the firm's annual income reporting system as the determining factor for computing the income of a decedent up to his death. It can, therefore, scarcely be material in this case whether the

firm is on a cash or accrual basis for reporting income. In this instance, just as in the *Guaranty Trust* case, the taxpayer is relying upon the firm system of accounting to avoid income taxation upon earnings derived and eventually paid over to his estate as a result of services rendered during his life. The purpose of Congress to tax to him who produces it all income derived as compensation for personal services can neither be overlooked nor so lightly cast aside. See *Irwin* v. *Gavit,* 268 U. S. 161, 166; *Lucas* v. *Earl,* 281 U. S. 111, 115. Compare *Helvering* v. *Horst,* No. 27, this Term. Under the *Bull* and *Guaranty Trust* cases, we submit, the earnings from services rendered prior to the death of the decedent are income earned by him in his lifetime and taxable as such.

2. (a) The situation before the Court may be considered from yet another point of view. Under the Estate Tax the interest of the decedent in the cash on hand, accounts receivable, and the earned proportion of unfinished business would clearly be included in determining the value of his gross estate. The items enumerated are well within the meaning of the words "property, real or personal, tangible or intangible, wherever situate" as used in the revenue acts. See *Burnet* v. *Houston,* 283 U. S. 223, 226; *United States* v. *Carter,* 19 F. (2d) 121 (C. C. A. 5th); *Nichols* v. *United States,* 64 C. Cls. 241, certiorari denied, 277 U. S. 584.

A series of cases in the Board of Tax Appeals and in the circuits courts of appeals has held that

similar items included in the gross estate of a decedent are capital, not income to the estate.[7] Thus obligations forming part of decedent's assets—such as for interest [8] and for salary earned during his life,[9] for rents accrued during his life,[10] and for dividends declared during his life but payable after his death [11]—are treated as capital and not as

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[7] See the cases collected in Paul & Mertens, *The Law of Federal Income Taxation*, Vol. 4, Sections 34.34–34.35. Only the excess collected over the value of the item at the date of death is taxable as income to the executor or the beneficiaries of the estate. *Eldredge* v. *United States*, 31 F. (2d) 924 (C. C. A. 6th); *William P. Blodgett et al., Exec.*, 13 B. T. A. 1243; *Estate of A. Plumer Austin*, 10 B. T. A. 1055; *Walter R. McCarthy, Exec.*, 9 B. T. A. 525; *Frank H. Clark, Exec.*, 12 B. T. A. 425. Cf. Sections 113 (a) (13), 113 (a) (5), Revenue Act of 1934; Article 113 (a) (13)–2, Treasury Regulations 86.

[8] *Mellie Esperson Stewart*, 18 B. T. A. 1010; *Frank H. Clark, Exec.*, 12 B. T. A. 425; *William K. Vanderbilt, Exec.*, 11 B. T. A. 291; *E. S. Heller, Exec.*, 10 B. T. A. 53; *William G. Frank, Adm.*, 6 B. T. A. 1071.

[9] *Jackson B. Kemper, Adm.*, 14 B. T. A. 931; *Frank H. Clark, Exec.*, 12 B. T. A. 425; *J. Howland Auchencloss, Exec.*, 11 B. T. A. 947; *Estate of A. Plumer Austin*, 10 B. T. A. 1055; *George Nichols et al., Exec.*, 10 B. T. A. 919 *Walter R. McCarthy, Exec.*, 9 B. T. A. 525.

[10] *Frank H. Clark, Exec.*, 12 B. T. A. 425; *William K. Vanderbilt et al., Exec.*, 11 B. T. A. 291.

[11] *Grahame and Richard D. Wood, Exec.*, 26 B. T. A. 533; Cf. *Clarence B. Davison, Exec.*, 20 B. T. A. 856, aff'd, 54 F. (2d) 1077 (C. C. A. 2d); GCM 6658, CB VIII–2, p. 309; *Wm. P. Blodgett et al., Exec.*, 13 B. T. A. 1243; *George Nichols et al., Exec.*, 10 B. T. A. 919; see also *Maurice L. Goldman*, 15 B. T. A. 134; *Nichols* v. *United States*, 64 C. Cls. 241 (1927), certiorari denied, 277 U. S. 584.

income to his estate when it receives payment. The same rule has been applied to the interest of a decedent partner in earnings derived from personal services rendered by his firm prior to his death. *Nichols* v. *United States,* 64 C. Cls. 241, certiorari denied, 277 U. S. 584. Compare *United States* v. *Carter,* 19 F. (2d) 121 (C. C. A. 5th).

The *Nichols* case arose upon facts strikingly like those here before the Court. The decedent there at the time of his death on April 25, 1920, was a member of a copartnership operating in New York as selling agents on commission. The articles provided that—

> In case of the death of any partner, his interest in the partnership shall cease with the last day of the month in which he dies and * * * shall be liquidated and paid over to his estate as fast thereafter as the proper conduct of the business will allow [64 C. Cls. at 244].

During the decedent's life, the firm performed some services, namely, it secured certain contracts. The commissions owing on these services were paid to the firm subsequent to the decedent's death—between April 25 and December 31, 1920—and were turned over to the decedent's estate as received. The Court of Claims held that the payments were received by the estate as capital, and need not be reported as income to it for the period April 25 to December 31 (64 C. Cls. at 245-246). This Court denied certiorari. 277 U. S. 584.

It was not considered material, in any of the cited cases, whether the decedent had been on a cash or accrual basis or whether the obligations forming part of his assets had ever been reported by him as income. The theory adopted in the cases was that income to the estate is only such income as is earned after the estate begins, i. e., after the decedent's death. Compare *Nichols* v. *United States,* 64 C. Cls. 241, 245, certiorari denied, 277 U. S. 584, with *Bull* v. *United States,* 295 U. S. 247, 255–256, wherein the income earned after the decedent's death, and paid to the estate as a member of the firm, was taxed to the estate, and income earned prior to his death was taxed as income to him and treated as capital to his estate.

The result of these decisions was that such items of income either had to be taxed to the decedent as income earned during his life or they escaped all taxation as income. Yet it was uniformly held (except as to the interest of a decedent in partnership earnings during his life, *Bull* v. *United States,* 295 U. S. 247) that income earned by an individual but not received during his life was not income to him in the event his books were kept on a cash receipts basis. Thus there was created a considerable breach in the income tax statutes contrary to the purpose of Congress to tax all income from whatever source derived. Compare *Irwin* v. *Gavit,* 268 U. S. 161, 168. Congress was thereupon asked to remedy the situation.

The method chosen by Congress was to declare in the Revenue Act of 1934, in effect, that income earned during the life of a decedent should be taxed as income to him during his life without regard to the fact that payment was made after death or that his books were kept on a cash receipts basis. Section 42 of the Act reads as follows:

> In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period. [U. S. C., Title 26, Sec. 42.]

There is no doubt either as to the circumstances which gave rise to this section or as to the purpose which Congress intended to accomplish. The legislative materials make both abundantly clear. The Report of the House Ways and Means Committee (H. Rep. No. 704, 73d Cong., 2d Sess., p. 24) states:

> *Sections 42 and 43.* Income accrued and accrued deductions of decedents: The courts have held that income accrued by a decedent on the cash basis prior to his death is not income to the estate, and under the present law, unless such income is taxable to the decedent, it escapes income tax altogether. By the same reasoning, expenses accrued prior to death cannot be deducted by the estate. Section 42 has been drawn to require the inclusion in the income of a dece-

> dent of all amounts accrued up to the date of his death regardless of the fact that he may have kept his books on a cash basis. Section 43 has also been changed so that expenses accrued prior to the death of the decedent may be deducted.

The Report of the Senate Finance Committee (S. Rep. No. 558, 73d Cong., 2d Sess., p. 28) reads:

> *Sections 42 and 43. Period for which deductions and credits taken.*—The courts have held that income accrued prior to the death of a decedent on the cash basis is not income to his estate, and under the present law, unless such income is taxable to the decedent, it escapes income tax altogether. By the same reasoning, expenses accrued prior to death cannot be deducted by the estate. Sections 42 and 43 of the House bill were so drawn as to require the inclusion in the income-tax return for the decedent of all items of income and deductions accrued up to the date of death regardless of the fact that the decedent may have kept his books on a cash basis. The change made in section 43 is necessary to effectuate the policy adopted in the House bill in section 42. By reason of the proposed change such items as accrued dividends and interest on partially tax-exempt securities are permitted as a credit in computing the normal tax.

The legislative materials cited thus confirm the meaning urged by the Government and show that

the purpose of Congress in enacting Section 42 was to reach all income earned during the life of a decedent that otherwise would escape the income tax whether derived from services performed as an individual or as a member of a partnership. The reference in each report to court opinions is plainly a reference to such cases, among others, as *Nichols* v. *United States,* 64 C. Cls. 241, certiorari denied, 277 U. S. 584, dealing with partnership earnings. The basis for this assertion is the fact that the *Nichols* case has been viewed by the Board as a leading authority and was strongly relied upon in support of its earlier decisions.[12] It is improbable that Congress in these circumstances could have intended that income earned during his life by a decedent as a member of a partnership should, alone, escape the reach of Section 42 and avoid being taxed as income. See *Irwin* v. *Gavit,* 268 U. S. 161, 168.

The income sought to be taxed to the decedent in the case at bar comes well within the principles announced in the *Nichols* case and therefore comes within reach of Section 42.

(b) There is nothing in the statutory provisions with respect to partnership income computation and reporting which militates against the Government's position. The historical development of these provisions indicates that partnership returns are merely informational and accounting conven-

[12] See cases cited in notes 8–11, *supra*, p. 20.

iences. The relevant section of the 1916 Act[13] provided that—

> Persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of the partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid * * *.

It is noteworthy, however, that there was no provision for a single annual partnership return of its income transactions. The 1916 Act, on the contrary, declared that——

> * * * such partnership, when requested by the Commissioner of Internal Revenue, or any district collector, shall render a correct return of the earnings, profits, and income of the partnership, * * * setting forth the item of the gross income and the deductions and credits allowed by this title, and the names and addresses of the individuals who would be entitled to the net earnings, profits, and income, if distributed.

Under these provisions, partnerships might be subjected to the considerable inconvenience of rendering a statement of earnings several times during a twelve-month period. The 1918 Act was therefore framed to avoid the difficulties experienced under the 1916 Act. The system of reporting partnership income then erected has been followed in all reve-

[13] C. 463, 39 Stat. 756, Section 8 (e).

nue acts since that time.[14] This system, briefly, provides that the income of a firm of partners shall be computed as in the case of an individual and that the distributive share of the net income of the firm whether distributed or not, shall be included in computing the net income of each partner. The firm is required to "make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed * * * [and] the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual."[15]

In the *Guaranty Trust* case this Court considered and rejected the argument that these provisions for reporting partnership income were determinative and could be used to avoid a tax upon income earned during life by a decedent as a member of a partnership even though such income might not appear on any firm return ending within his taxable year (pp. 11-12, *supra*).[16]

The recent decision of the Court in *Neuberger* v. *Commissioner*, No. 5, this Term, sheds further light on the function of the partnership income computing and reporting system. There, a deduction from gross income was allowed for losses from sales or exchanges of stocks and bonds held less than two years but only to the extent of the gains

[14] See note 5, *supra*, p. 17.

[15] E. g., Sections 181-189, Acts of 1934, 1932, 1928, 1926.

[16] See note 3, *supra*, p. 12.

from similar sales or exchanges. The Commissioner urged that losses sustained in an individual capacity could not be offset against gains from similar transactions on the part of the firm in view of the provisions for a separate computation of firm income and individual income. This Court held that the partnership income accounting provisions were not controlling since to permit such an offset was in accordance with the intention of Congress. The intention of Congress in Section 42 to reach the income here sought to be taxed is shown by very convincing evidence. It is therefore immaterial that Section 42 does not expressly modify the partnership accounting provisions of the 1934 Act. The latter must give way to the general purpose of Congress that income earned during the life of decedent shall not escape taxation as his income.

3. The Board found that the decedent's share of the outstanding accounts and the earned proportion of unfinished business came within the words "amounts accrued up to the date of his death" in Section 42 (R. 15). On the record in this case the Board's finding is unassailable. The outstanding accounts on the books of the firm clearly would be viewed as accrued under any system of accrual accounting. *Continental Tie & L. Co.* v. *United States*, 286 U. S. 290, 296. The only problem arises in connection with the earned proportion of receipts from unfinished business. The evidence as to the latter may be briefly reviewed (see Statement, *supra*, pp. 4–5).

At the date of decedent's death his firm was handling 400 pending cases on which work had been done and on which additional work had to be done before the fees to be charged could be determined and billed to clients. The surviving senior partner of the firm, James D. Carpenter, Jr., appraised each case and determined that the probable amount earned by the firm, up to the date of decedent's death, aggregated $118,422.51 of which decedent's share was 34½% or $40,855.77. Nine of the cases pending in the firm were being handled on a fixed fee basis, payable per month or per annum after his death, and the decedent's share in the amounts earned prior to his death was $1,024.89. All contingent fee cases were valued at one dollar each. Substantially all of the remaining matters pending were being handled upon understandings with clients that the fee would be a reasonable amount for work done, taking into account results, time and effort, and the amount involved. The actual collections up to the date of trial exceeded the amount estimated as the aggregate value of the 400 pending cases.

The Board observed (R. 15) that "the share in the fixed fee items were certainly accruable. The evidence does not show the situation in regard to the other items making up the $40,855.77 in sufficient detail to enable the Board to determine whether or not they were accruable. Some of them may have been sufficiently definite to permit an accrual, while others may have been too indefinite or con-

tingent. We must decide the case upon the record before us. That record does not show that any of the estimated fees were too indefinite for accrual of the amount fixed by Carpenter and consequently we are unable to say that less than $42,911.32 [$2,055.55 was from accounts outstanding] was income under section 42."

(a) The Board's opinion (R. 15) cites the case of *Lillian O. Fehrman, Executrix,* 38 B. T. A. 37, likewise involving Section 42, and thus indicates that in reaching its conclusion it relied upon the concepts of accrual income accounting stated therein. The criteria discussed and applied in the *Fehrman* case and applied in the case at bar clearly come within the narrowest definition of the accrual basis of accounting. The *Fehrman* opinion indicates that the Board construes Section 42 as requiring not only that the right to receive items taxed as income to a decedent shall be fixed at the date of his death but also that the amount shall be definitely ascertainable on the basis of the facts then known (38 B. T. A. at 42). These criteria are surely as rigid as any that this Court has ever laid down with respect to ascertaining whether items have accrued for the purpose of making a periodic report of income. E. g., *Continental Tie & L. Co.* v. *United States,* 286 U. S. 290; *American National Co.* v. *United States,* 274 U. S. 99; *United States* v. *Anderson,* 269 U. S. 422. The rule of law thus applied by the Board scarcely can be thought prejudicial to the decedent taxpayer.

The application of this governing rule of law in the circumstances of this case therefore presented only a question of fact within the competence of the Board to decide. The evidence shows that the right to receive payment in some amount on the cases handled on a *quantum meruit* basis had clearly become fixed by the date of decedent's death. It also shows that the aggregate amount then ascertained as having been earned was in fact received with a sum to spare. We submit, therefore, that the evidence supports the finding as made. The taxpayer, in any case, can scarcely be deemed to have met the burden of proving that the Commissioner's deficiency determination was wrong. See *Burnet* v. *Houston*, 283 U. S. 223.

(b) In addition, the Government contends that the criteria for determining whether an item has "accrued" under Section 42 are not nearly so rigid as the Board's opinion here and in the *Fehrman* case would indicate. The term "accrued" as used in the 1934 Act is not defined with particularity. Section 48 (c) states that "The terms 'paid or incurred' and 'paid or accrued' [in Section 43] shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part." Under the general rule stated in Section 41 the computation of net income "shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income" (pp. 35–37, *infra*). Article 41–1 of Regulations 86 likewise states that "the time as

of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income" (p. 40, *infra*). Similar provisions have appeared in every revenue act and the regulations promulgated thereunder since the Revenue Act of 1918.[17] Even the optional provisions of the 1916 Act were given a similar construction. See *United States* v. *Mitchell*, 271 U. S. 9, 12; *Aluminum Castings Co.* v. *Routzahn*, 282 U. S. 92, 98. In view of this history, the so-called "accrual basis" of computation can scarcely be deemed to have any precise meaning apart from the circumstances of a given taxpayer's case. It is merely a short-hand expression for designating that manner of computation permitted by the Commissioner in order to achieve a clear reflection of a taxpayer's income as contrasted with the "cash basis" which, though concededly inaccurate, is allowed in some instances in the interests of convenience. See *United States* v. *Anderson*, 269 U. S. 422, 436–438; *Aluminum Castings Co.* v. *Routzahn*, 282 U. S. 92, 96–99.

Section 42 cannot fairly be construed without reference to this historical background of the statutory provisions requiring the so-called accrual

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[17] See 1934, 1932, 1928 Acts, Section 41; 1926, 1924, 1921, 1918 Acts, Section 212 (b); Regulations 86, Articles 41–1, 41–3; Regulations 77 and 74, Articles 321, 323; Regulations 69, 65, 62, 45, Articles 22, 24.

basis of computing net income. When viewed in this setting the critical word "accrued" in Section 42 assumes its proper meaning. It then ceases to connote a specific, arbitrary set of criteria. It no longer compels the determination of every case by some procrustean rule. The words "amounts accrued up to the date of his death" when viewed as part of the whole picture come to mean amounts which clearly reflect the taxpayer's entire income up to the date of his death. This construction is not only in complete accordance with the background of the "accrual basis" and with the general purpose of Congress to tax all income from whatever source derived. *Irwin* v. *Gavit,* 268 U. S. 161, 166. Compare *Lucas* v. *Earl,* 281 U. S. 111, 115; *Helvering* v. *Horst,* No. 27, this Term. It may fairly be deemed essential to avoid nullification of the purpose described with particularity in the legislative materials bearing on the enactment of Section 42 (pp. 23–25, *supra*). Those materials show beyond question that the motivating cause of Section 42 was a group of decisions permitting certain income to escape taxation as such (pp. 23–25, *supra*). It would be anomolous to hold that Congress has again failed to accomplish what it obviously intended.

The income sought to be taxed to the decedent in this case clearly comes within the meaning thus attributable to Section 42. All of the items assessed by the Commissioner were earned through the efforts of the decedent and his partners as

practicing attorneys and the share thus attributed to the decedent may fairly be viewed as compensation for his personal services during his lifetime. The right of the decedent to appoint these items by will or to transfer them by deed of gift or for an immediate cash consideration cannot be doubted. Compare *Helvering* v. *Hurst*, No. 27, this Term. In every real sense these items created by his own efforts and subject to his disposition during his life are income earned by him during his life. We submit that under Section 42 they should not be permitted to escape taxation as such.

CONCLUSION

It is submitted that, for the foregoing reasons, the decision of the Circuit Court of Appeals is erroneous and should be reversed with directions to affirm the decision of the Board of Tax Appeals.

Respectfully,

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FEBRUARY, 1941.

APPENDIX

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 11. NORMAL TAX ON INDIVIDUALS.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 4 per centum of the amount of the net income in excess of the credits against net income provided in section 25.

* * * * *

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly.

* * * * *

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year. (For use of inventories, see section 22 (c).)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period (U. S. C., Title 26, Sec. 42).

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits provided for in this title shall be taken for the taxable

year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. In the case of the death of a taxpayer there shall be allowed as deductions and credits for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly allowable in respect of such period or a prior period.

* * * * *

SEC. 48. DEFINITIONS.

When used in this title—

(a) *Taxable Year.* — "Taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part. "Taxable year" includes, in the case of a return made for a fractional part of a year under the provisions of this title or under regulations prescribed by the Commissioner with the approval of the Secretary, the period for which such return is made.

* * * * *

(c) *Paid, incurred, accrued.*—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

* * * * *

(U. S. C., Title 26, Sec. 48.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity (U. S. C., Title 26, Sec. 181).

SEC. 182. TAX OF PARTNERS.

There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year (U. S. C., Title 26, Secs. 182, 188).

SEC. 183. COMPUTATION OF PARTNERSHIP INCOME.

The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual.

SEC. 187. PARTNERSHIP RETURNS.

Every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners (U. S. C., Title 26, Sec. 187).

SEC. 188. DIFFERENT TAXABLE YEARS OF PARTNER AND PARTNERSHIP.

(a) *General rule.*—If the taxable year of a partner is different from that of the partnership, the distributive share of the net income of the partnership to be included in computing the net income of the partner for his taxable year shall be based upon the net income of the partnership for any taxable year of the partnership (whether beginning on, before, or after January 1, 1934) ending within the taxable year of the partner.

* * * * *

New Jersey Revised Statutes (1937), Vol. II, Title 42:

PARTNERSHIPS AND PARTNERSHIP ASSOCIATIONS

ARTICLE 6. DISSOLUTION AND WINDING UP.

42:1-29. *Dissolution defined.*—The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business.

42:1-30. *Partnership not terminated by dissolution.*—On dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed.

42:1-31. *Causes of dissolution.*—Dissolution is caused:

* * * * *

4. By the death of any partner;

* * * * *

42:1-43. *Right to accounting on dissolution.*—The right to an account of his interest shall accrue to any partner, or his legal representative, as against the winding up partners, or the surviving partners, or the person or partnership continuing the business, at the date of dissolution, in the absence of any agreement to the contrary.

Treasury Regulations 86, relating to the Revenue Act of 1934:

ART. 41-1. *Computation of net income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year.

Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See articles 42–1 to 42–3.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

ART. 41–3. *Methods of accounting.*—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. * * *

ART. 42–1. *When included in gross income.*—Except as otherwise provided in section 42 in the case of the death of a taxpayer, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different pe-

riod in accordance with the approved method of accounting followed by him. (See articles 41–1 to 41–3.) If a taxpayer has died there shall also be included in computing net income for the taxable period in which he died amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period, regardless of the fact that the decedent may have kept his books and made his returns on the basis of cash receipts and disbursements. * * *